STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CHARLES AND HELENA ROZIER	:	DETERMINATION DTA NO. 819958
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1999, 2000 and 2001.	:	

Petitioners, Charles and Helena Rozier, 35 Compo Beach Road, Westport, Connecticut 06880, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1999, 2000 and 2001.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on July 12, 2005 at 10:30 A.M., with all briefs submitted by November 18, 2005, which date began the six-month period for the issuance of this determination. Petitioners appeared by Peter L. Faber, Esq. and Alysse Grossman, Esq. The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Peter B. Oswald, Esq., of counsel).

ISSUE

Whether certain income earned by petitioner Charles Rozier, a nonresident of New York, was derived from or connected with New York sources and therefore taxable by New York.

FINDINGS OF FACT

1. During the years in issue, petitioner Charles Rozier was an industrial designer who was in the business of designing office furniture.[1] This activity included the planning, conceptualization, design and documentation of new products.

2. Prior to 1989, petitioner resided at 134 24th Street, Apt. 5-R, New York, New York. From 1989 until June 1998, petitioner's returns listed his address as 40 East 9th Street, New York, New York. Beginning with his return for 1998, petitioner listed his address as 209 Hillsport Road, Westport, Connecticut, and determined his New York tax liability as a nonresident.

3. Knoll North America, Inc. ("Knoll") was a firm which was in the business of producing and selling residential and office furniture. It had an office in New York City.

The Morrison Agreement

4. In January 1983, petitioner entered into an agreement with Knoll whereby petitioner agreed to advise Knoll regarding the design and marketing of an office panel system known as the Morrison office system. The Morrison office system was unlike anything that was on the market at the time and consisted of many parts, including hardware, panels, work surfaces, brackets, storage elements, power and lighting, in order to provide a work environment that could be tailored to a customer's specifications in a corporate office. One business publication characterized the Morrison office system as "the most functional high-performance system available."

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[1] Helena Rozier is a party to this proceeding solely because she and Charles Rozier filed joint income tax returns for the years at issue. Accordingly, unless otherwise indicated, all references to "petitioner" herein shall refer to Charles Rozier.

5. The Morrison office system became a very important product for Knoll. It brought Knoll from being a niche manufacturer of speciality furniture items into the broad corporate interiors market. Its product line is now dominated by such systems.

6. Under the Morrison Agreement, Knoll agreed to pay Mr. Rozier a percentage of sales of the Morrison office system in exchange for: (a) Mr. Rozier's services; (b) Mr. Rozier's agreement not to compete with Knoll; and (c) permission for Knoll to use Mr. Rozier's name when marketing the Morrison office system. The Morrison Agreement did not specifically allocate any portion of the royalties to either the agreement not to compete with Knoll or the right to use Mr. Rozier's name when marketing the Morrison office system.

7. The parties reserved the right to terminate the Morrison Agreement upon six months prior written notice to the other party. The pertinent paragraph provided as follows:

> 2. The term of your retention hereunder shall commence on January 1, 1983 (the "Effective Date") and terminate on December 31, 1987 unless sooner terminated by your death or disability or in accordance with this paragraph 2 (hereinafter called the "Consulting Period"). Thereafter, this agreement shall automatically be extended for five (5) additional one-year periods. Anything contained herein to the contrary notwithstanding, either of us shall have the right to terminate this agreement during the initial or any renewal term upon six (6) months prior written notice to the other party. It is understood, however, that the termination of this agreement will not affect your continuing rights under paragraph 4 of this agreement to receive royalties from the exploitation of the Design Products.

8. Although the Agreement did not specifically allocate a portion of the royalties to the agreement not to compete, in fact 50 percent of the royalties paid by Knoll to Mr. Rozier were attributable to the agreement by Mr. Rozier not to compete with Knoll. The noncompetition provision was very important to Knoll and accounted for a large portion of the payments to Mr. Rozier under the Morrison agreement. Mr. Rozier had a very extensive knowledge of the market where the Morrison office system would be offered and far more knowledge of the market than

anyone else at Knoll. Further, since Mr. Rozier had a background in engineering, design and marketing he wrote what became the marketing strategy for Knoll's office furniture system. Mr. Rozier would have been a significant threat to Knoll if he had taken the information in his possession to a competitor. At the time the Morrison Agreement was signed, the market for office systems was growing rapidly and it was vital to Knoll to penetrate and grow with the market. The provision of the Morrison Agreement governing competition provided:

> (a) During the period that you are receiving compensation and/or royalties from Knoll, you shall not: (i) directly or indirectly solicit, raid, entice or induce any employee of Knoll or any of its subsidiaries to be employed by any person, firm or corporation which is, directly or indirectly, in competition with the business or activities of Knoll or any of its subsidiary or affiliated companies; or (ii) directly or indirectly approach any such employee for these purposes; or (iii) authorize or knowingly approve the taking of such actions by other persons on behalf of such person, firm or corporation, or assist any such person, firm or corporation in taking such action.
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> (b) During the period that this agreement is in effect and for a period of eighteen months thereafter, you shall perform services for, either as an employee, consultant, advisor, shareholder, partner or principal, any manufacturer or upholstered office systems or modular office landscape systems in connection with modular office panel systems competitive with that which is referred to in this agreement.

9. If a noncompetition clause had not been included in the Morrison Agreement, petitioner could have competed with Knoll by going to one of Knoll's competitors and providing them with some of the same services provided to Knoll. This would have caused economic harm to Knoll because nearly every aspect of the Morrison system's strategic and functional implementation was traceable to petitioner.

10. The importance of the noncompetition clause in the Morrison Agreement is evidenced by its length and detail. The typical agreement entered into by Mr. Rozier did not have noncompetition provisions. Occasionally, there was a contract which provided that Mr. Rozier could not provide any services that were competitive for a year and a half after the design work,

which usually took two years, was completed. In contrast, the Morrison Agreement was in effect for the original 5-year term plus 5 automatic 1-year renewal terms plus an additional 18 months.

11. Under the Morrison Agreement, Mr. Rozier permitted Mr. Knoll to use his name in marketing the Morrison office system. The Morrison Agreement stated:

> When appropriate, Knoll will have the right to include the phrase: “systems planning by Charles Rozier” in all advertising, promotion and sales material disseminated in connection with the Design Products. The phrase may also appear in the manner currently used by Knoll to credit designers on each relevant page of all price lists, planning guides, instructional booklets and similar materials used in connection with the Design Products.

12. The use of a designer’s name in advertising its product was an established practice at Knoll. At the time the Morrison Agreement was written, nearly every product was named after the designer. As time went on and products became more complex requiring a greater team effort, the products started being given businesslike names such as Currents.

13. Again, although not accounted for in the Agreement, in fact 25 percent of the payments to petitioner were for Mr. Rozier’s permission to use his name when advertising the Morrison office system.

The Currents Agreement

14. In 1995, Mr. Rozier entered into a second agreement with Knoll known as the Currents Agreement. Under this agreement, petitioner agreed to design and invent a new office system and to turn over the intellectual property rights to Knoll. The Currents Agreement stated:

> 2.1 DESIGNER will use his best efforts to design the PRODUCT to meet or exceed BIFMA, DIN and UL performance standards and to have aesthetic and functional characteristics, cost objectives and other attributes outlined in the MARKETING BRIEF, a copy of which is attached hereto and made a part hereof as Exhibit A. . . .
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> 2.2 DESIGNER SHALL complete a conceptual design of the PRODUCT in accordance with the MARKETING BRIEF and submit a written report thereon, including sketches, to Knoll on or before January 1, 1996.

> 2.3 Within 90 days of DESIGNER'S submission of the conceptional design under Paragraph 2.2, Knoll will notify DESIGNER, in writing, of its acceptance of the conceptional design (including any suggested modifications) of KNOLL's desire to reject the conceptual design and discontinue design work under this Agreement.
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> 2.4 Provided that Knoll has given DESIGNER notice of approval as provided under Paragraph 2.3, Designer shall cooperate with KNOLL to produce a full-scale prototype of the PRODUCT on or before May 1, 1996.
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> * * *
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> 3.2 DESIGNER agrees that all copyrightable [sic] works (including computer programs), inventions and discoveries (developments) made, conceived, or authorized under this Agreement by DESIGNER alone, or jointly with others, which arise out of or pertain to the PRODUCT, together with all intellectual property rights including but not limited to patents, copyrights, trade secrets, and trademarks as may be obtained on these developments are the property of KNOLL and DESIGNER hereby assigns and agrees to assign all right, title and interest therein to KNOLL. . . .

15. Knoll agreed to pay petitioner a percentage of the royalties it earned and received from the sales of the Currents office system in exchange for petitioner's transfer of his designs under the Currents office system.

16. Petitioner developed the products and had the designs patented. In accordance with the Currents agreement, the rights to the patents were immediately transferred to Knoll prior to the issuance of the patents by the patent office. Petitioner never exploited or used the patents.

Petitioner's Work Arrangements

17. Petitioner was not required to report to Knoll concerning the methods or details by which he performed his services under the Morrison or Currents agreements. Knoll did not control the hours that petitioner worked under the Morrison or Currents agreements. The amount that Knoll paid petitioner under either agreement did not have any correlation to the amount of time that he worked. Petitioner did not participate in any medical or retirement plans with Knoll while performing under the Currents or Morrison agreements. Knoll did not

withhold any taxes from the income that it paid to petitioner under either the Currents or Morrison agreements.

18. When petitioner was working under the Currents or Morrison agreement, he operated from a studio that he leased through an S corporation named Charles Rozier Associates, Inc. The corporation held the lease on the studio. At some juncture the name of the corporation was changed to Rozier Studio, Inc. There were periods when the studio had employees who performed design work. During the years 1986 to 1998, the corporation was located at 270 Lafayette Street, New York, New York. Knoll did not reimburse petitioner for the rental expense.

19. In order to invent the patentable designs under the Currents Agreement, petitioner used drawing tools and machine shop equipment such as a drill press and lathe. He also used a computer. Petitioner provided his own tools.

20. Petitioner performed industrial design services for entities other than Knoll at the time he was also creating patentable designs under the Currents agreement and performing services for Knoll under the Morrison agreement. The services performed for entities other than Knoll were different from what petitioner did for Knoll in that they were strictly design service agreements which were confirmed by a letter or handshake. Other than Knoll, petitioner never entered into any agreement whereby he would exclusively design patents for assignment to the entity. For other companies, petitioner was expected to devise a design for a product and provide documentation that the client could understand. The transfer of a patent was almost never part of the job.

21. Petitioner hired a subcontractor named James Petronio to assist him in the development of designs he was contracted to create under the Currents Agreement. Petitioner

paid Mr. Patronio for his services. Knoll did not participate in the hiring or supervision of Mr. Petronio.

22. Generally, Mr. Petronio did not have any contact with Knoll. However, on occasion, Mr. Petronio would accompany petitioner to a meeting or presentation.

23. Mr. Rozier was a resident of New York and conducted his business activities in New York at the time he performed his duties under the Currents and Morrison Agreements. Petitioner did not continue to work in New York after he moved to Connecticut.

24. Petitioner received the following royalties from Knoll under the Morrison Agreement for the years 1999 through 2001:

Year	Amount of Royalties
1999	$581,846.32
2000	$739,763.25
2001	$631,652.43

25. Petitioner received the following amount of royalties from Knoll under the Currents Agreement for the years 1999 through 2001:

Year	Amount of Royalties
1999	$184,679.83
2000	$577,232.63
2001	$616,149.61

Procedural Matters

26. On April 18, 2003, following an audit, the Division of Taxation ("Division") issued to petitioners, Charles and Helena Rozier, a Notice of Deficiency (Assessment # L-022220297-1) which asserted additional income tax due in the amount of $219,546.94, plus interest, for the years 1999, 2000 and 2001. The deficiency arises from the Division's determination that the

sums paid to Charles Rozier by Knoll during the years in issue constituted New York source income and therefore were subject to New York income tax.

27. Petitioners requested a conciliation conference which was conducted on October 7, 2003. Thereafter, the conciliation conferee issued a Conciliation Order, dated January 16, 2004, which recomputed the amount of tax asserted to be due to $194,001.98. The revision of the notice was attributable to a reduction of the amount of the Currents Agreement royalties by the amount of the payments made by Mr. Rozier to James Petronio.

CONCLUSIONS OF LAW

A. The New York personal income tax law imposes tax on the New York source income of a nonresident individual (Tax Law § 601[e]). Said income includes the net amount of items of income, gain, loss and deduction reported in the Federal adjusted gross income that are "derived from or connected with New York sources" (Tax Law § 631[a]). Insofar as relevant herein, the phrase "derived from or connected with New York sources" means income attributable to a business, trade, profession or occupation carried on in New York or income from intangible personal property "only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on" in New York (Tax Law § 631[b][1][B]; [2]).

B. In its brief, the Division argues that petitioner's income under the Currents Agreement was taxable to New York as income derived from or connected to a business, trade, profession or occupation carried on in New York pursuant to Tax Law § 631. Petitioner argues that the income from the Currents Agreement was from the disposition of an intangible. In response, the Division takes the position that this characterization of the income is not determinative.

C. In order to resolve the issues presented, it is first necessary to characterize the nature of the income in issue. In ***Gilson v. Commissioner*** (48 TCM 922) the Tax Court was called upon to decide whether the payments which the taxpayer received from the sale of a patent which a company had retained him to develop was compensation for services, which were taxable as ordinary income, or payments for rights to patents, which would qualify for capital gains treatment. The Court concluded that the taxpayer, who was an independent contractor, was entitled to capital gains treatment on the sale of a patent that the company had engaged him to develop. The Court reasoned as follows:

> This rule that an employer is the equitable owner of the invention his employee has been specifically engaged to produce depends on the existence of an employment relationship. The rule does not apply outside of an employment relationship, so that an independent contractor, although specifically engaged to create a design or invention, is still the owner of the design or invention and the patent rights. Petitioner was not an employee of any of his clients but was a self-employed independent contractor. Accordingly, petitioner did not lose his patent rights in his designs simply because he contracted with his clients to create those designs.
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> . . . The taxpayer's obligation from the outset to assign his inventions to the other party does not render unavailable the benefits of section 1235-it is unimportant whether the contract to assign is viewed as executory, so that no "transfer" occurs until formal assignment and payment, or whether the payment is viewed as relating back to a previous transfer of patent rights.
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> The determinative question is whether the payments petitioner received under his design contracts constituted consideration for his transfer of all substantial rights to his patentable designs or consideration for the performance of personal services. Resolving this factual issue is difficult because "an invention is merely the fruit of the inventor's labor, and . . . payment for the invention itself necessarily compensates the inventor for his services in creating the invention." We are persuaded, however, and have found as a fact that petitioner's customers paid him for his patentable designs, not for his services.
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> The objective of petitioner's clients in contracting with him was to obtain designs for their products. Under the terms of the design contracts, petitioner became entitled to his fees only as he produced and delivered designs. If he did not produce a design, he was not entitled to payment. By contrast, a person hired for

his services generally gets paid whether or not his services produce anything useful. (***Gilson v. Commissioner, supra,*** 48 TCM at 927-928.)

D. The record clearly supports the finding that petitioner was an independent contractor.[2] Therefore, he was the owner of the patents until he they were assigned to Knoll. Moreover, as pointed out by petitioner, the provisions of the Currents Agreement clearly establish that Knoll engaged Mr. Rozier for the transfer of the patents and not the performance of services. Accordingly, on the basis of the ***Gilson*** case, it is concluded that the income which petitioner received under the Currents Agreement was from the disposition of an intangible.

E. The next question presented is whether the income received pursuant to the Currents Agreement was derived from or connected to a New York source. As set forth above, the Tax Law provides that income received by a nonresident from an intangible is derived from or connected to a New York source "only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on" in New York (Tax Law § 631[b][1][B]; [2]).

F. The Division maintains that the income from the disposition of the patents is New York source income and that petitioner's argument ignores the timing of the contract and its terms as well as the connection that petitioner and Knoll had to New York in 1995 and throughout the years in issue. Specifically, the Division calls attention to the fact that in 1995 petitioner and Knoll entered into the Currents Agreement which granted Knoll rights to petitioner's designs, that in 1995 petitioner was a New York resident who was involved with a New York design firm and that Knoll was located in New York City. The Division further

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[2] The Division has not challenged petitioner's assertion that he was an independent contractor. In view of the fact that Knoll was primarily concerned with the results achieved by petitioner and not the manner by which such results were accomplished as well as the other factors set forth in Findings of Fact "17" through "21," petitioner's contention that he was an independent contractor is accepted (***see, Matter of Manhattan Fire Extinguisher, Inc.***, Tax Appeals Tribunal, September 18, 1997).

argues that upon execution of the Currents Agreement in 1995, petitioner did not have a property right to grant. Consequently, it is submitted that petitioner's argument that in order to have New York source income he would have had to employ the patents in a business before or after the transfer is raising form over substance.

In the alternative, the Division further notes that when the assignment of the patents under the Currents Agreements took place on May 31, 1997, petitioner was still operating as an industrial designer in a New York based industrial design firm. Similarly, Knoll was engaged in a business carried on in New York.

G. The arguments raised by the Division are irrelevant. According to the statute, when a taxpayer becomes a nonresident of New York, the only relevant factor in determining whether the income is subject to tax by New York is whether the intangible is used in a business, trade, profession or occupation carried out by the taxpayer in New York (Tax Law § 631[b][1][B]; [2]). As explained by petitioner, the fact that the intangible was conveyed pursuant to a contract that was executed when the parties were residents or located in New York has no bearing on the matter. Thus, in ***Matter of Albanese*** (Tax Appeals Tribunal, July 17, 1997), the fact that the covenant not to compete was executed while the taxpayer was a resident of New York, did not make the income paid pursuant to the covenant taxable after the taxpayer became a nonresident. Under the circumstances, the income in issue is not subject to New York personal income tax.

H. The Division next argues that the Morrison Agreement does not contain a valid covenant not to compete, and therefore the income received under the Morrison Agreement is taxable as income derived from or connected to a New York source. There are several difficulties with this argument. First, the Division's argument does not focus on the appropriate test. The Tribunal has stated that in order to determine whether income is derived from or connected with New York sources:

> it is necessary to identify the activity upon which the income was secured or earned . . . [and that] in making this determination, *the consideration given by petitioner* in exchange for the right to the income at issue *is the controlling factor* (***Matter of Laurino***, Tax Appeals Tribunal, May 20, 1993; emphasis added).

I. Under the test identified by the Tribunal, the question is not whether a particular contract clause satisfies certain legal requirements. Rather, it asks what was the consideration given by petitioner. Here, petitioner obviously believed that at least a portion of the consideration that he was giving was the relinquishing of the right to enter into certain types of employment relationships for a particular period of time.

J. The Division argues that the income received by petitioner is not linked to the noncompetition clause because Mr. Rozier would continue to receive the royalty income even if he began working for a competitor. The Division's interpretation of the contract is mistaken. The second paragraph of the Morrison Agreement describes certain events which will result in the continued payment of royalties despite the termination of the contract - petitioner's death, disability or termination by either party to the contract upon six-months notice. A violation of the noncompetition clause is not one of those events. Further, the Division's reading of the contract is nonsensical. There would be no point in including a noncompetition clause in a contract if the parties intended that the clause could be simply ignored.

K. The Division contends that the Morrison Agreement neither provides for payment to petitioner for the use of his name nor that 50 percent of the royalties should be allocated to the noncompetition clause. Therefore, the Division maintains that no amount should be allocated to either item. According to the Division, petitioner has incorrectly designated the income received from Knoll under the Morrison Agreement as intangible royalty income when the income is, in fact, derived from petitioner's services in New York. It is submitted that 100 percent of the income received by petitioner under the Morrison Agreement is taxable as income derived from or connected to a New York source.

L. The forgoing argument is unpersuasive. Petitioner has shown that the modern trend of authorities is to recognize the "economic reality" of a transaction (***National Service Industries, Inc. v. United States of America***, 379 F Supp 831; 73-2 US TaxCas ¶ 9703). Clearly, the record establishes that the economic reality of the agreement between petitioner and Knoll was that there was a clear benefit to Knoll from petitioner's not developing a system which would be competitive with the Morrison office system. The affidavit of the then president of Knoll stating that petitioner was in a position to cause Knoll significant economic damage by competing with it is very plausible. In addition, the use of petitioner's name in order to market the office system was an additional economic benefit to Knoll. Moreover, petitioner has shown through his own credible testimony and through the affidavit of the president of Knoll at the time the Morrison Agreement was executed that a proper allocation of the royalties would be 25 percent for the use of petitioner's name for promotional purposes and 50 percent for petitioner's agreement not to compete.

M. Contrary to the Division's argument, the acceptance of the forgoing allocation does not violate the parol evidence rule. The evidence explaining the intention of the parties regarding the Morrison Agreement was admissible because it was not being offered to vary, modify or supply an omission in the provisions of an unambiguous written instrument (***see, generally***, Fisch, New York Evidence § 56 et seq [2d ed 1977]).

N. In accordance with the forgoing, the income which Mr. Rozier received under the Currents Agreement and 75 percent of the income which Mr. Rozier received under the Morrison

Agreement was not New York source income and, therefore, not subject to New York State personal income tax.

O. The petition of Charles and Helena Rozier is granted to the extent of Conclusion of Law "N" and the Division of Taxation is directed to adjust the Notice of Deficiency, dated April 18, 2003, in accordance with this determination, and in all other respects the petition is denied.

DATED: Troy, New York
May 18, 2006

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE